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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

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In the Matter of	)	
	)	
Implementation of Section of the Cable Television Consumer Protection and Competition Act of 1992: Rate Regulation	)	MM Docket 93-215

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PETITION FOR RECONSIDERATION

BEND CABLE COMMUNICATIONS, INC.
ETAN INDUSTRIES, INC.
PARCABLE, INC.
RIVER VALLEY CABLE TV
STAR CABLE ASSOCIATES

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May 16, 1994

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SUMMARY

The cable companies submitting these comments are all small business (independent operators and small MSOs) organized as Subchapter S Corporations or partnerships ("Companies"). Although they were pleased that the Commission shifted from its original position and decided to allow these forms of business entities an allowance for tax liability, the Companies do not believe that the Commission's policy, which mandates a deduction from the tax allowance of all distributions the company makes to shareholders or partners, will provide a fair rate of return. This policy falls most harshly on small cable companies, which tend more frequently to be organized as Subchapter S Corporations or partnerships. In addition, the Companies object to the disparate treatment of interest deductions as between C Corporations and Subchapter S Corporations. They urge the Commission to allow a full allowance for tax liability attributable to the earnings of the cable enterprise and parity of treatment with respect to interest deductions for all cable companies, regardless of their form of organization.

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PETITION FOR RECONSIDERATION

Bend Cable Communications, Inc.; Etan Industries, Inc.; ParCable, Inc.; River Valley Cable TV and Star Cable Associates (the "Companies"), by their attorneys and pursuant to Section 1.429 of the Commission's rules, hereby seek reconsideration of interim cost-of-service rules promulgated by the Commission in the Report and Order and Further Notice of Proposed Rulemaking in MM Docket No. 93-215, FCC 94-39 (rel. March 30, 1994) (the "Order").

The Commission, on numerous occasions, has stated that its cost-of-service procedures are to serve as a "safety net" to insure a fair return on investment for cable operators that are unable to obtain such a return under its benchmark procedures. [1] In several respects, the interim cost-of-service rules fall short of the viable safety net that the Commission intended them to be. The Companies are concerned in particular about one issue: the ability of cable companies organized as Subchapter S corporations, sole

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[1] See, e.g. Order at ¶4; Notice of Proposed Rulemaking in MM Docket 93-215, FCC 93-353 (released July 16, 1993), at ¶5; Report and Order and Further Notice of Proposed Rulemaking in MM Docket No. 92-266 (rel. May 3, 1993) at 264.

proprietorships or partnership to include taxes incurred in the provision of regulated cable services in determining their annual expenses.[2]

The Companies, all small businesses organized either as Subchapter S corporations or partnerships,[3] participated actively in previous phases of both the Commission's benchmark and cost-of-service proceedings. In their comments, replies and meetings with Commission staff, treatment of tax liability was an issue of paramount importance. Specifically, the Companies opposed the Commission's tentative proposal to preclude companies not organized as C Corporations ("C Corps") to include taxes incurred in the provision of regulated cable services in determining their expenses.

The Companies were pleased that the Commission's interim cost-of-service rules departed from the approach originally

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2 See Notice of Proposed Rulemaking, MM Docket No. 93-215, FCC 93-353 (released July 16, 1993) at ¶30, n.32.

3 Bend Cable Communications, Inc.(owner and operator of one cable television system serving 16,000 subscribers in Central Oregon), River Valley Cable TV (with a system serving 3600 subscribers in rural townships near Williamsport, Pennsylvania, Etan Industries, Inc. and affiliated companies (operating 40 headends with only 44,461 total subscribers in Louisiana, Mississippi, Texas and Nevada) and ParCable, Inc. (with four headends in Kentucky and Tennessee, ranging from approximately 12,000 subscribers on the largest headend to slightly over 1,000 subscribers on the smallest) all are organized as Subchapter S corporations. Star Cable Associates, a partnership, has 60 headends in Ohio, North Carolina, South Carolina, Texas and Virginia, serving slightly over 1,000 subscribers each.

proposed and did permit these types of business organizations an allowance for taxes as part of their operating expenses. Unfortunately, the rules imposed certain conditions on this allowance that once again result in a failure to achieve Congressionally intended regulatory neutrality among different forms of business organizations. By failing to afford the tax liability attributable to earnings of Subchapter S corporations ("Sub-S Corps"), individual proprietorships and partnerships rate treatment comparable to that afforded the tax liability of C Corps, the rules pose a particular burden on small cable operators, which are more likely to select these forms of organization.

The Liability of Various Forms of Business Entities

Sub-S Corps, partnerships and sole proprietorships (which are referred to collectively hereinafter as Sub-S Corps unless otherwise stated) are not tax exempt entities; like the more common form of business entity -- the C Corp, they generate revenues that are subject to taxation.

As column I of Example A shows, income taxes have the same effect on the cash flow of a cable entity, regardless of its legal organization - C Corp or Sub-S Corp.[4] The principal difference is how the income taxes actually get

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[4] The top Federal income tax rate is higher for Sub-S Corp owners (39.6%) than it is for C Corps (35.0%).

paid to the taxing authorities. A C Corp pays the IRS (and state and local taxing authorities) directly based on the net taxable income shown on its IRS corporate income tax Form 1120. The Sub-S Corp (or partnership) summarizes its taxable income items on a Schedule K showing its net taxable amount and sends this form to the IRS and its shareholders. The Sub-S corporation (or partnership) also prepares a Schedule K1 showing each shareholder's allocation of the net taxable income shown on Schedule K and sends this form also to the IRS and its shareholders (or partners). The Sub-S corp shareholders (or partnership partners) include their respective allocations of the Sub-S Corp's (or partnership's) net taxable income on their IRS Form 1040's Schedule E. It is customary that the Sub-S Corp (or partnership) pays the amount of the income tax due on its operations to its shareholders (or partners) in the proportions shown on Schedule K1. The shareholders (or partners), in turn, pay the IRS these taxes at the personal income tax rates.

Impact of FCC Policy in General

Even if the underlying investment and cost structures of a C-corp and a Sub-S Corp are the same, columns II and III of Example A show that the Sub-S Corp will have lower revenues than the C Corp under the new rules, solely because of the legal organization of the owner of the system. Likewise, the

Sub-S Corp will have less cash flow retained in its business after paying for income taxes resulting from its operations than the comparable C Corp. Therefore Sub-S Corps will be at a competitive disadvantage to reinvest in their cable systems to take advantage of all the most recent technological advances to the ultimate detriment of their subscribers. Also the Sub-S Corp's return on investment will effectively have been substantially reduced below the 11.25% rate otherwise allowed by the rules. Such "below C-Corp" and "fair" allowed returns will induce Sub-S Corp shareholders to withdraw capital from Sub-S Corp cable entities, further limiting the cable entity's ability to reinvest in new technologies - again, to the ultimate detriment of its subscribers.

Impact of Offset of Distributions on Tax Allowance

A problem arises because the new rules do not take into account the fact that as a practical matter, a Sub-S Corp is expected to distribute funds to its shareholders to allow them to pay for the income taxes the Sub-S Corp's cable operations created. (If the company did not do so, it would have difficulty attracting or retaining investors.) Such distributions are, functionally, no different than a C Corp paying its income taxes directly to the taxing authorities. The rules need to treat these income tax-related payments of funds the same way as C Corp income tax-related payments to reflect the true underlying nature of the business transactions regardless of the type of entity providing the services.

To put it another way, income tax-related distributions to Sub-S Corp shareholders are analogous to income tax payments to taxing authorities by C Corp, <u>not</u> to dividends paid by C Corp to shareholders, which dividends are available to shareholders for any personal use whether related to income tax payments or not. Such Sub-S Corp distributions use the same "pre-corporate tax" dollars as C Corps to pay for income taxes due on the Sub-S Corp's cable operations. These funds just go to the taxing authorities via the Sub-S Corp shareholders rather than directly.

The Commission errs in equating Sub-S Corp distributions to cover shareholders' share of income taxes attributable to the operation of the cable business entity and dividends paid to shareholders of C Corps.

The income tax being paid through such Sub-S Corp distributions to shareholders is based on the "taxable income" (return of investment) of the cable enterprise, not the individual's other personal income and expenses. The income tax being paid by the shareholders on the return on investment of the cable business entity is based on the cable business entity's return on investment, <u>not</u> the amount of funds being distributed to the shareholders to pay the related income taxes. These related income taxes would have to be paid by the shareholders whether or not the cable entity made distributions to them to cover the payment of these related income taxes.

It is true that if the distributions were not made to cover such cable business entity-related income taxes, shareholders of Sub-S Corps would still have to pay the related income taxes; however, they would have to use other personal resources. Of course, not everyone has such personal resources and therefore it is customary to have these income taxes paid by the cable business entity through distributions to shareholders.

If other personal resources were used to pay these related income taxes, such investors' returns on investment would be correspondingly reduced. The possibility of having to use other personal resources, if available, and the thereby having a substantially reduced return from a Sub-S Corp cable business investment would make it virtually impossible to attract and keep investors in Sub-S Corp cable business enterprises. To say it another way, there are no income taxes that arise because of the distribution to Sub-S Corp shareholders, but rather only income taxes that arise due to the operations of the cable business entity.

Therefore cable business entity-related income taxes would be the ONLY income taxes ever recovered from subscribers whether distributions to Sub-S Corp shareholders occur or not, in conformity with the Commission's intent as described in Paragraph 138 and footnote 296 of Paragraph 139 of the Order.

Impact of Pre-Regulatory Decisions

Another problem with the structure of the new rules is that they mix actual results (for 1991 and, possibly, 1993 for FCC Form 1205 and 1993 for FCC Form 1220) with the after-the-fact theoretical construct of "return on investment".

Sub-S Corp distributions to shareholders in 1991 and 1993 were made with no way of knowing the FCC would use these distributions in a manner that would adversely inhibit the recovery of a tax allowance on a construed return on investment under future cable rate rules. Thus many Sub-S Corps will be severely penalized for reasons having nothing to do with their cost structures or construed return on investment results. Any number of unique circumstances could have resulted in a decision to make distributions to Sub-S Corp shareholders at these particular times. It is patently unfair to penalize Sub-S Corps for taking actions they could have had no knowledge would hurt them in future rate settling rules.

Practical Result of New Policy

Perhaps the best example of why the rules cannot work as intended is the comparison of two Sub-S Corp cable companies - one of which had taxable income in 1991 and 1993 and therefore made distributions to its shareholders to pay for income taxes arising because of the cable operation's taxable income and the other of which had tax losses for 1991 and 1993.

Under the new rules the Sub-S Corp which had taxable income and had to make payments to its shareholders to pay the related income taxes will not be entitled to full recovery (if to any recovery) for income tax liability attributable to its construed return on investment. However the Sub-S Corp which actually showed a loss and therefore made no distributions to its shareholders will experience full recovery for income tax liability attributable to its construed return on investment. Clearly the one company that should not have its income tax recovery impaired is the former.[5] In this example, the results actually are the

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[5] It is noted that as rate-regulated entities under a cost-of-service approach, cable companies in the future will not show losses for their rate-regulated services, because the cost of service approach is geared to insuring a certain level of profit. Accordingly, few if any cable companies organized as Sub-S Corps will receive full or any allowance for tax liability.

opposite of what even common sense would indicate is appropriate.

Above Income Related Shareholder Distribution

Even where C Corp dividends are paid to individuals subject to individual taxes, as the Commission pointed out in paragraph 138 and footnote 296 to paragraph 139 of the Order, regulators do not allow the recoupment of these individual income taxes in rate setting. However neither do regulators make a deduction from any other cost or return factor for these distributions of after-corporate income tax amounts.

In this situation, "excess" distributions to Sub-S Corp shareholders (above the amount needed to pay income taxes related to the Sub-S Corp cable operations) are the same as a C Corp's dividends to its shareholders in their effect on the cable business entity, as can be seen in columns I and II of Example A. Further, such distributions create no additional shareholder income taxes and therefore there is nothing additional for which to ask subscribers for recoupment. Therefore such distributions should be treated similar to C Corp dividends in the cable rate setting rules.

Further any deduction of such "excess" distributions from the construed return on investment will make it impossible to have a full recoupment of the income taxes attributable to the "true" construed return on investment.

By requiring deduction of <u>all</u> distributions from the tax allowance, the Commission is, in effect, defeating the very purpose of affording a tax allowance in the first place -- namely, acknowledging that the payment of taxes on income attributable to a company's earnings is a legitimate expense of doing business regardless of the level at which the tax is paid.

Therefore any distributions to shareholders by either C Corps or Sub-S Corps should <u>not</u> be taken into consideration in the rate setting rules.

<u>Interest Deductions</u>

The same logic holds true for any interest deduction. Both a C Corp and a Sub-S Corp will deduct interest expenses when calculating their respective taxable incomes from their cable operations. Therefore the interest deduction will reduce taxable income the same for a C Corp as for a Sub-S Corp. This deduction will have the same effect on the amount of income tax that a C Corp will have to pay the taxing authorities as it will have on the amount a Sub-S Corp will have to distribute to its shareholders to pay for the income taxes arising from the operations of the Sub-S Corp cable operations. The effect on the respective cable business entities is essentially the same.

Yet, the FCC gave no reason for treating the interest deduction differently for a C Corp than for a Sub-S Corp.

Since the effect on the cable business entity is the same, there should be no disparate treatment between a C Corp and a Sub-S Corp for any interest deductions.

Conclusion

The allowance for income taxes on the imputed return on investment and the treatment of any interest deduction should be the same for Sub-S Corps as it is for C Corps, because: (1) at least up to the top corporate tax rate, the effect of income taxes and any interest deduction on the cable business entity is the same; (2) otherwise the disparately treated cable business entity will be unable to earn a fair return on its investment; and (3) thereby the allowance for income taxes and any interest deduction will have a neutral effect on subscriber rates, regardless of the legal form of ownership of a cable system.

For these reasons, the Companies urge the Commission to allow cable businesses organized as Sub-S Corps, partnerships or sole proprietorships an allowance for tax liability attributable to the earnings of the cable business without any deduction for distributions to shareholders, owners or partners. In addition, the Companies urge the Commission to treat the interest deductions for all forms of business entities in the same manner. By doing so, the Commission will allow cable operators, particularly those that are small businesses, to earn a fair rate of return while organizing their companies in the form that is most appropriate to their size and circumstances.

Respectfully submitted,

BEND CABLE COMMUNICATIONS, INC.
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Example A

Comparison of Disparate Effects of New Rules On Income Tax Reimbursement Between C Corporations and S Corporations, Partnerships and Sole Proprietorships ("S Corp's")

Assumed Actual Results For 1993 For Both C Corp And S Corp Cable Company Examples: (Using New Rules Foremat) | **First Year's Results Assuming Same Expense Structure But New Rate Rules:**

		I Results For C Corp & S Corp Cable Companies	II For C Corp - Allowed For Rate Setting		III For S Corp - Allowed For Rate Setting	
A	Net Investment In Assets	$10,000,000		$10,000,000		$10,000,000
B	Fair Rate of Return p.a.	11.25%		11.25%		11.25%
C	Fair Return On Investment p.a. (A * C)	$1,125,000		$1,125,000		$1,125,000
C1	New Rules' Net Offset To Return (1993 Capital Infusions Less Shareholder Distributions)		n/a		($393,750)	
B1	Effective Net Offset Return On Invested Capital p.a. ((C-C1)/A) (For Information Only)		n/a		7.31%	
C2	Net Offset Return On Investment (C-C1)		n/a		$731,250	
D	Annual Income Taxes On Return- IF Only Federal Income Taxes @ 35.0%	$393,750		$393,750		$255,938
E	Annual Expenses, Other Than Income Taxes and Interest	$3,000,000		$3,000,000		$3,000,000
F	Annual Interest Expense	$500,000		$500,000	$500,000	
F1	New Rules' Tax Effect Offset Of Interest Expense		n/a		$175,000	
F2	New Rules' After Tax Effect Interest Expense		n/a			$325,000
G	Subtotal = E + F =	$3,500,000		$3,500,000		$3,325,000
H	Annual Revenue (C + D + G)	$5,018,750		$5,018,750		$4,705,938
I	C Corp Earnings (C)	$1,125,000		$1,125,000		
J	C Corp Income Taxes and Dividends (Equals S Corp Distribution)	($393,750)		($393,750)		
K	C Corp Earnings Retained In Business	$731,250		$731,250		
L	S Corp Earnings (C)	$1,125,000				$1,125,000
M	S Corp Distributions To Shareholders (Solely Equals Total Income Taxes To Be Paid)	($393,750)				($255,938)
N	Other S Corp Cash Out Flows Not Reimbursed Through Rate Setting	$0				($175,000) (Tax Effect On Interest)
O	S Corp Earnings Retained In Business	$731,250				$694,063

Notes:

1. **For Puposes of Illustration, This Example Uses The Top Federal Rate For C Corp's, Even Though The Top Rate For S Corp's Owners Is Higher (39.6%).**
2. **S Corp Must Charge Less Than C Corp And Therefore Has Less To Reinvest In Business Than C Corp, Despite Same Fundamental Cost Structure and Pre-Tax Return On Investment.**
3. **Interest Has Same Effect On C Corp's and S Corp's Cable Entities Cash Flows, Absent New Rate Setting Rules.**
4. **If S Corp Was Treated Same As C Corp, Effect On Cable Entity Cash Flows And Cable Subscribers' Rates Would Be Identical.**
5. **S Corp's Will Make Distributions To Shareholders For Income Taxes On Cable Entity Earnings (Return On Investment), And The New Rules Would Not Allow These Distributions For Income Taxes To Be Reimbursed Through Rates, Thereby Effectively Lowering The Net Return On Investment For a S Corp.**